

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE AMENDED APPLICATION OF ORCHARD)	
GRASS SANITATION, INC., FOR AN ORDER)	
PURSUANT TO CHAPTER 278 OF THE)	
KENTUCKY REVISED STATUTES)	CASE NO. 8193
AUTHORIZING AN ADJUSTMENT IN RATES)	
FOR THE EXISTING SEWAGE TREATMENT)	
PLANT SERVING ORCHARD GRASS HILLS)	
SUBDIVISION, OLDHAM COUNTY, KENTUCKY)	

O R D E R

On March 31, 1981, Orchard Grass Sanitation, Inc., ("Orchard Grass") filed an application with this Commission for authority to increase its rates for sewer service by \$88,959 annually, an increase of 256 percent based on year-end customers. Based on the determination herein the annual revenue will increase by \$4,238, an increase of 12 percent.

On May 18, 1981, the Commission issued an Order scheduling a hearing for July 9, 1981, and directing Orchard Grass to provide notice to its customers of the proposed rate increase and the scheduled hearing.

Motions to intervene were filed by the Division of Consumer Protection in the Department of Law ("Attorney General"), the City of Orchard Grass Hills, and Larry Smither and other customers of Orchard Grass. At the hearing it was indicated that the two latter intervening parties

were jointly represented by one counsel ("City"). All motions to intervene were sustained by the Commission, and the hearing was conducted as scheduled.

Briefs were filed by Orchard Grass, Attorney General, and City on July 27, 1981. Orchard Grass has responded to requests for additional information, and the matter is now before the Commission for final determination.

On July 27, 1981, Orchard Grass filed a Motion for Authorization to Issue Evidence of Indebtedness. The Commission, pursuant to KRS 278.300, considered the motion as an amendment to the application in this matter and requested additional information in support of the motion. No additional hearings were conducted on this issue. Response to the Commission's request for additional information was received on November 10, 1981.

Test Period

The Commission has accepted the 12-month test period ending December 31, 1980, for the purpose of determining the reasonableness of the proposed rates. In utilizing the historical test period the Commission has included adjustments found to be known and measurable to reflect more current operating conditions.

Commentary

Orchard Grass is a privately-owned sewage treatment system organized under the laws of the Commonwealth of

Kentucky. Orchard Grass provides sewage treatment service to 325 customers within the area of Orchard Grass Hills Subdivision in Oldham County, Kentucky.

Orchard Grass is a wholly-owned subsidiary of Titan Development Corporation ("Titan Development") with principal offices in Paramus, New Jersey. Titan Development is a wholly-owned subsidiary of Titan Group, Inc., ("Titan Group"), also of Paramus, New Jersey.

Revenue and Expenses

Orchard Grass proposed adjustments to revenue and expenses on Exhibit U to the application. The Commission has considered all of the proposed adjustments and has made the following modifications to the test period:

Operating Revenue

The Commission has increased operating revenue by \$980 to include the total revenue that would be billed annually based on the number of customers at the end of the test period.

Maintenance and Repairs

Orchard Grass proposed to increase maintenance and repair expense by \$1,903. The witness for Orchard Grass, Mr. Casey, testified that the increase was simply a 25 percent increase based on the increase of 30 percent in the same account during 1980. The Commission is of the opinion that the projected increase is merely an estimate which is not known and measurable and should not be allowed herein. We have, however, reviewed the "supplemental list of projected

expenses" filed as Exhibit 6 at the hearing and find that the repair and maintenance expense should be increased by \$440 to include the additional cost of \$170 for painting a building, \$250 for road maintenance and \$20 for the NPDES permit.

Insurance

Initially Orchard Grass proposed to increase insurance expense by \$1,192 based on the prepaid insurance for 1981. However, upon submission of appropriate documentation it was evident that the actual cost was only \$633. Therefore, the Commission has reduced the test year insurance expense by \$1,080 to reflect the actual cost for 1981.

Taxes, Utilities and Miscellaneous

Orchard Grass proposed adjustments to taxes, utilities and miscellaneous expenses for expected cost increases based on increases experienced during 1980. The Commission is of the opinion that adjustments of this nature are arbitrary in nature and do not reasonably project the level of expense that may be incurred in the future. Therefore, these adjustments have not been allowed for rate-making purposes. However, we have adjusted taxes to reflect the additional \$962 for 1980 taxes paid during 1981.

Salaries and Fringe Benefits

Orchard Grass proposed to reduce salaries and fringe benefits expense by \$10,373 to exclude the portion of the manager's salary which was improperly charged to utility operation. The remaining expense of \$5,550 in this account

represents 20 percent of the manager's annual salary and the bookkeeper's salary of \$663 per year. Mr. Casey testified that Safeco Insurance Company pays 80 percent of the manager's salary under a contractual arrangement. The remaining 20 percent is paid by Orchard Grass. The record in this matter does not support the contention of Orchard Grass that it should pay 20 percent of the manager's salary. It is evident that the daily operations of the sewer plant are taken care of under an agreement with Eubank, Hall and Associates, Inc. Customer billing and collections are handled by the Louisville Water Company and the financial aspects of Orchard Grass are supervised by Mr. Casey. Therefore, the Commission finds that the annual expense for the manager's salary should be reduced to \$1,200 for rate-making purposes. The amount of salary allowed herein is based on allowances of similar utilities for employees with similar supervisory functions.

Parent Company Overhead

Orchard Grass proposed to increase operating expenses by \$4,500 for costs allocated from the parent company. Mr. Casey testified that this amount included \$3,000 for Titan Group employees and \$1,500 for miscellaneous charges for office space, equipment use and various supplies. No evidence was offered as to the cost of specific services provided to Orchard Grass by Titan Group other than that provided by Mr. Casey. He testified that the miscellaneous expenses were merely an estimate of use of office equipment and various supplies and that his estimate of the amount of time involved

in Orchard Grass affairs by employees of Titan Group would be about 120 hours at a cost of \$25 per hour. Titan Group is a multi-million dollar corporation of which Orchard Grass is a minute segment. While the Commission is of the opinion that parent company services are essential to a parent-subsidary relationship, we do not find justification for the proposed \$4,500 allocation of parent company overhead to Orchard Grass. The Commission will allow \$1,500 to cover necessary management related costs and operating supplies.

Depreciation and Interest

Orchard Grass proposed an adjustment to reduce depreciation expense by \$1,943 to exclude depreciation on a portion of its treatment facilities which are not in service. Based on the findings of the Commission on Orchard Grass' request for authority to issue evidence of indebtedness the Commission will not allow depreciation or interest expense for rate-making purposes herein.

Income Taxes

Orchard Grass did not propose an adjustment for federal and state income taxes. The Commission has included a provision of \$1,131 based on the level of net income allowed herein and the applicable state and federal tax rates.

All other pro forma adjustments not specifically mentioned herein have been accepted by the Commission as proposed. Based on the allowed pro forma adjustments Orchard Grass' pro forma operating statement is as follows:

	<u>Actual Test Period</u>	<u>Pro Forma Adjustments</u>	<u>Adjusted Test Year</u>
Operating Revenue	\$ 33,730	\$ 980	\$34,710
Operating Expenses	60,170	(27,027)	33,143
Net Income	<u>\$(26,440)</u>	<u>\$ 28,007</u>	<u>\$ 1,567</u>

The Commission finds that an operating ratio of 88 percent is fair, just and reasonable and should be used in determining revenues for Orchard Grass. This level of income will allow Orchard Grass to pay its operating expenses and provide a reasonable return. In order to achieve this level of income on an adjusted test year basis, Orchard Grass is entitled to increase its rates to produce total revenues of \$38,948 which will require an increase of \$4,238 annually.

Evidence of Indebtedness

In this case Orchard Grass has requested authorization to issue evidence of indebtedness to its parent, Titan Development, for funds which it claims were advanced by Titan Development to finance the construction of the treatment plant and to recover cash deficits from prior years. Interest on the claimed advance would be at the prime rate of Midlantic National Bank/Citizens of Englewood, New Jersey.

By definition, transactions between a subsidiary and its parent are not at arms-length and must be scrutinized by the Commission. The agreement was executed by Orchard Grass, Titan Development and Titan Group on March 26, 1981, without Commission approval.

Orchard Grass requested and the Commission ordered the incorporation in this proceeding of the record in Case No. 6683.

On December 10, 1976, the Commission issued an interim Order in Case No. 6683 authorizing Orchard Grass to construct additional sewage treatment facilities. The record in that matter is clear as to the intent of Orchard Grass, Titan Development, and Titan Group with regard to financing of the cost of building the sewage treatment plant. The application stated in Section 5:

Initial construction costs and financing of the project are to be funded by the petitioner. Operation and maintenance of the system will be financed by imposition of a sewer use charge to be imposed upon each customer.

In its interim Order issued in Case No. 6683, the Commission required Orchard Grass to file an amended application requesting adequate rates. Orchard Grass filed its amended application on March 16, 1978, which contained a statement of actual operations for the year ended December 31, 1977, and projections of operating expenses through 1982. Neither the actual expenses nor the projected expenses contained a provision for interest expense in determining the revenue requirements. Failure to request interest expense on capital required to finance the treatment plant further demonstrates that Orchard Grass did not intend to recover the interest costs associated with this facility from its customers.

The final Order of the Commission issued on January 16, 1979, allowed no interest costs on capital required to finance the treatment plant in determining revenue requirements.

Indeed, the Commission pointed out in that Order that sewage utilities such as Orchard Grass "are unique to the extent that the cost of facilities has usually been included in the cost of the individual lot."^{1/} The exclusion of interest costs by the Commission in that Order was not contested by Orchard Grass.

It is clear to the Commission that the original intent of Orchard Grass and Titan Development was to recover the cost of the treatment plant through the sale of lots. There is no other logical reason why Orchard Grass would not have requested the recovery of the cost of this capital in its original rates in Case No. 6683. The Commission concludes that the record in this matter, when considered in conjunction with the record in Case No. 6683, does not support the contention that Orchard Grass did not intend to recover the cost of the sewage treatment plant through the sale of lots.

With respect to the claimed debt and associated costs connected with the financing of cash deficits from prior years, the Commission assumes the intent is to obtain revenues sufficient to cover the debt cost and repayment of principal.

^{1/}
p. 2. Case No. 6683, Order issued January 16, 1979,

Sound rate-making would require losses from operations to be recorded as reductions in the equity of the stockholders. The burden of obtaining sufficient revenues to pay operating costs rests with the utility. Orchard Grass' failure to seek sufficient revenues to cover its operating costs in prior periods does not justify its request to set up the costs of these prior periods as accounts payable to its parent and recover them from today's ratepayers. The Commission is of the opinion that granting this request would be retroactive rate-making.

For the above reasons the Commission concludes that the request to issue a certificate of indebtedness to Titan Development is unreasonable and should be denied.

Summary

The Commission, having considered the evidence of record and being advised, is of the opinion and finds that:

1. The rate in Appendix A is the fair, just and reasonable rate for Orchard Grass and will produce gross annual revenue sufficient to pay its operating expenses and provide a reasonable surplus for equity growth.
2. The rate proposed by Orchard Grass would produce revenue in excess of that found to be reasonable herein and therefore should be denied upon application of KRS 278.030.
3. Orchard Grass has not met its burden of proof that the evidence of indebtedness is for a lawful object within the corporate purposes of the utility or that the financing

arrangement is necessary or appropriate for or consistent with the proper performance by the utility of its service to the public as required by KRS 278.300.

4. The application to issue evidence of indebtedness should be denied.

IT IS THEREFORE ORDERED that the rate in Appendix A, attached hereto and made a part hereof, is approved for service rendered by Orchard Grass on and after January 31, 1982.

IT IS FURTHER ORDERED that the rate proposed by Orchard Grass is hereby denied.

IT IS FURTHER ORDERED that within 30 days from the date of this Order Orchard Grass shall file with the Commission its revised tariff sheet setting out the rate approved herein.

IT IS FURTHER ORDERED that the application of Orchard Grass to issue evidence of indebtedness is hereby denied upon application of KRS 278.300.

Done at Frankfort, Kentucky, this 1st day of February, 1982.

PUBLIC SERVICE COMMISSION

Marlin M. Doty
Chairman

Barbara B. Bussell
Vice Chairman

Jim Carrigan
Commissioner

ATTEST:

Secretary

APPENDIX

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO. 8193 DATED FEBRUARY 1, 1982

The following rate is prescribed for customers served by Orchard Grass Sanitation, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the effective date of this Order.

<u>Class of Customer</u>	<u>Monthly Rate</u>
Single-Family Residential	\$10.00